2003

Corporate Control Transactions: Introduction

Edward B. Rock
University of Pennsylvania Carey Law School

Michael L. Wachter
University of Pennsylvania Carey Law School

University of Pennsylvania
Law Review
FOUNDED 1852

Formerly
American Law Register

VOL. 152 DECEMBER 2003 NO. 2

SYMPOSIUM

CORPORATE CONTROL TRANSACTIONS

INTRODUCTION

EDWARD B. ROCK & MICHAEL L. WACHTER

Control transactions—a category that includes friendly mergers, hostile tender offers, management buyouts, freeze-outs, and sales of control by a controlling shareholder—stand at the conceptual and practical center of corporate law and governance. These transactions transformed the world during the turbulent 1980s and 1990s, and will do so again during the equally turbulent 2000s.

In February 2003, in the wake of turmoil in boardrooms and markets, the University of Pennsylvania's Institute of Law and Economics and the Law Review, with cosponsorship by the Sloan Foundation and the Saul A. Fox Research Endowment, gathered leading scholars and judges to focus sustained attention on the topic. The twelve articles that are published in this volume are the result.

The articles interestingly fell into four categories: precommitment and managerial incentives; investors' choice; the boundary between markets and doctrines; and views from the bench.

I. PRECOMMITMENT AND MANAGERIAL INCENTIVES

The first set of articles focus on reasons why reasonable shareholders might intelligently choose some level of insulation from a competitive market for corporate control. These articles collectively represent a fundamental reevaluation of the academic consensus. Since the beginning of the 1980s takeover boom, mainstream academic opinion has ranged across a fairly narrow spectrum. In the first round of the debate, Easterbrook and Fischel represented one position with their argument that target management should remain passive.[1] The principal alternative position was articulated separately by Ronald Gilson and Lucian Bebchuk, who argued that managers should be able to employ limited defensive tactics that would allow them to seek competing bids.[2] The three articles in this section argue, on various grounds, that more robust defensive measures can be justified.

In *Corporate Constitutionalism: Antitakeover Charter Provisions as Precommitment*,[3] Marcel Kahan and Edward Rock view the allocation of decision-making authority within a constitutional choice of governance framework. They maintain that the decision to endow directors with substantial power over deciding whether and how to sell the firm may be a completely rational choice for some companies, and when shareholders have chosen such a structure, that decision should be respected. For them, the debate between shareholder choice and management discretion should not focus on universal mandates, but rather should adopt an approach that recognizes that the same regime may not be optimal for all firms. On both theoretical and empirical grounds, it may be perfectly sensible for shareholders to opt for board entrenchment, implemented, for example, by means of a staggered board. This would enable a board to employ selling strategies

---

[1] *See* Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1164 (1981) (arguing for board passivity).

[2] *See* Lucian A. Bebchuk, Comment, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028, 1050-56 (1982) (arguing for limited board discretion to solicit competing bids); Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 821 (1981) (same).

[3] Marcel Kahan & Edward B. Rock, *Corporate Constitutionalism: Antitakeover Charter Provisions as Precommitment*, 152 U. PA. L. REV. 473 (2003).

more effectively and thus to increase the premium that shareholders receive when the company is sold. By binding themselves ex ante with such a precommitment, shareholders may be able to improve their collective position ex post. After examining how shareholders can entrench particular governance structures under Delaware law, they examine two issues that arise once shareholders have chosen to entrench a governance structure: the question of incomplete implementation that arises in cases such as *Blasius*[4] and *Liquid Audio*;[5] and the questions of when and whether changed circumstances justify ex post judicial negation of shareholders' prior commitments.

In *Corporate Policy and the Coherence of Delaware Takeover Law*,[6] Richard Kihlstrom and Michael Wachter develop a model that supports a coherent theory of Delaware takeover law. They show that by incorporating corporate policy as a key variable in the model, Delaware law, by allowing for management discretion, can be shown to be best suited for maximizing the value of the corporation and the shareholders' interest under a set of reasonable assumptions. By presenting a corporate policy model that accounts for occasional market mispricing and the agency costs associated with managing to the market, they demonstrate that a shareholder choice regime would likely lead to suboptimal investment decisions. In their model, managers are assumed to have better information regarding alternative corporate policies than shareholders but may, in certain circumstances, act to maximize share price in order to insulate themselves from hostile tender offers, even at the expense of maximizing firm value. This theory explains the result in *Paramount v. Time*,[7] and also the reason why shareholder choice is allowed in limited instances that implicate *Revlon* duties such as *Interco*[8] and *Paramount v. QVC*.[9]

In *Unregulable Defenses and the Perils of Shareholder Choice*,[10] Jennifer Arlen and Eric Talley argue that even if shareholders enjoy a comparative advantage over management in reacting to hostile bids, it does not follow that a shareholder choice regime is value enhancing,

---

[4] Blasius Indus. v. Atlas Corp., 564 A.2d 651 (Del. Ch. 1988).

[5] MM Cos. v. Liquid Audio, Inc., 813 A.2d 1118 (Del. 2003).

[6] Richard E. Kihlstrom & Michael L. Wachter, *Corporate Policy and the Coherence of Delaware Takeover Law*, 152 U. PA. L. REV. 523 (2003).

[7] Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140, 1152 (Del. 1989).

[8] City Capital Assoc. v. Interco Inc., 551 A.2d 787, 802 (Del. Ch. 1988).

[9] Paramount Communications, Inc. v. QVC Network Inc., 637 A.2d 34, 43 (Del. 1994).

[10] Jennifer Arlen & Eric Talley, *Unregulable Defenses and the Perils of Shareholder Choice*, 152 U. PA. L. REV. 577 (2003).

because it would give managers an incentive to search for ways to thwart prospective oversight, perhaps even through value-destroying managerial choices that render the firm an unattractive takeover target. They demonstrate and provide empirical support for the hypotheses that (a) a number of such thwarting defenses exist, (b) managerial threats to use them are credible, and (c) regulation by courts would be highly impractical. That leads them to the conclusion that an immutable, one-size-fits-all shareholder choice rule is likely to be an unwise policy choice for courts.

II. INVESTORS' CHOICES

A second set of articles looks carefully at the question of what it is that investors choose. In *The Shareholder as Ulysses: Some Empirical Evidence on Why Investors in Public Corporations Tolerate Board Governance*,[11] Lynn Stout explores the foundations of shareholder choice by asking why investors in public corporations reveal a preference for ceding control over the corporation's assets and outputs to a board of directors, rather than retaining control for themselves. Stout reviews two theories of why public corporations are controlled by boards of directors: the monitoring model, and the mediating model. She evaluates the strength of each model in light of the empirical evidence, including emerging empirical evidence on incorporation patterns and charter provisions in initial public offerings. She concludes that while the issue has not been resolved with certainty, at this point the mediating model enjoys superior empirical support both as a positive description of how public corporations are governed and as a normative prescription for how investors prefer they be governed. Accordingly, she argues, the burden of proof should shift to those who favor the monitoring model.

In *Why Firms Adopt Antitakeover Arrangements*,[12] Lucian Bebchuk examines a puzzle for people who think that antitakeover arrangements hurt shareholders, namely, how is it that firms going public have increasingly been incorporating antitakeover provisions in their IPO charters, while shareholders of existing companies have increasingly been voting in opposition to such charter provisions? Bebchuk identifies and analyzes a variety of possible explanations for this empirical pattern, including explanations based on (1) the role of antitakeover

---

[11] Lynn A. Stout, *The Shareholder as Ulysses: Some Empirical Evidence on Why Investors in Public Corporations Tolerate Board Governance*, 152 U. PA. L. REV. 667 (2003).

[12] Lucian Arye Bebchuk, *Why Firms Adopt Antitakeover Arrangements*, 152 U. PA. L. REV. 713 (2003).

arrangements in encouraging founders to break up their initial control blocks, (2) efficient private benefits of control, (3) agency problems among pre-IPO shareholders, (4) agency problems between pre-IPO shareholders and their lawyers, (5) asymmetric information between founders and public investors about the firm's future growth prospects, and (6) bounded attention and imperfect pricing at the IPO stage. Bebchuk then goes on to trace out policy implications of the possible explanations, including the appropriate default rules. The analysis, in contrast to the articles presented in the first section, argues for limits on contractual freedom at the IPO stage. Finally, the analysis suggests that it might be desirable for corporate law to use sunset strategies, requiring that entrenching arrangements adopted by charter provisions lapse after a certain period unless renewed by a shareholder vote.

In *Institutional Shareholders, Private Equity, and Antitakeover Protection at the IPO Stage*,[13] Michael Klausner takes a different approach to a related institutional investor schizophrenia: There has been limited response by institutional investors to the prevalence of takeover defenses in the charters of firms whose shares they hold. Klausner argues that "[i]nstitutional investors' hesitancy may reflect a rational unwillingness among private equity funds—as well as the institutions' own investment staff . . .—to require portfolio companies to go public with takeover-friendly charters."[14] He raises the possibility that reputational concerns, such as the need to be viewed as working well with successful managers of portfolio companies, seem to account for both the presence of defenses in IPO charters and the tepid response by institutional investors. If this is the case, then it may be "privately rational, but socially inefficient, for private equity funds to have their portfolio companies adopt takeover defenses."[15] The result is that it is no easier to purge takeover defenses from IPO charters than to urge managers of public firms to do so themselves.

III. DOCTRINES AND MARKETS

A third set of articles examined key doctrinal questions that arise at the borderline between capital markets and law.

---

[13] Michael Klausner, *Institutional Shareholders, Private Equity, and Antitakeover Protection at the IPO Stage*, 152 U. PA. L. REV. 755 (2003).

[14] *Id.* at 784.

[15] *Id.*

In *Controlling Controlling Shareholders*,[16] Ronald Gilson and Jeffrey Gordon examine the rules governing controlling shareholders. They start from the insight that, from public shareholders' standpoint, controlling shareholders present a tradeoff. A controlling shareholder has an incentive to keep an eye on managers, but may be tempted to take private benefits of control. Non-controlling shareholders will prefer the presence of a controlling shareholder so long as the benefits from reduction in managerial agency costs are greater than the costs of private benefits of control. Gilson and Gordon argue that a controlling shareholder may extract private benefits of control in one of three ways: by taking a disproportionate amount of the corporation's ongoing earnings, by freezing out the minority, or by selling control. Their thesis maintains two propositions: First, they assert that the limits on these three methods of extraction must be symmetrical because they are in substantial respects substitutes. Second, they suggest that current Delaware doctrine points in inconsistent directions: on the one hand, reducing the extent to which a controlling shareholder can extract private benefits through selling control, and on the other, increasing the extent to which private benefits can be extracted through freezing out non-controlling shareholders. For Gilson and Gordon, Delaware gets it backwards: the potential for efficiency gains are greater from sales of control than from freeze-outs, so a shift that favors freeze-outs as opposed to sales of control is a move in the wrong direction. In particular, they argue that the best method of reunifying the Delaware law of freeze-outs is to first, give business judgment rule protection to transactions that are approved by a genuinely independent special committee that has the power to say "no" to a freeze-out merger. Second, a class-based appraisal remedy should be preserved for transactions that proceed by freeze-out tender offer without special committee approval.

In *Appraising the Nonexistent: The Delaware Courts' Struggle with Control Premiums*,[17] William J. Carney and Mark Heimendinger examine the shifting definition and role of "control premiums" in Delaware's appraisal jurisprudence. The complexity arises because of the Delaware Supreme Court's conclusion that the Delaware appraisal statute entitles dissenting shareholders to the pro rata value of their firm and that the market price of any firm's stock reflects an implicit minority

---

[16] Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785 (2003).

[17] William J. Carney & Mark Heimendinger, *Appraising the Nonexistent: The Delaware Courts' Struggle with Control Premiums*, 152 U. PA. L. REV. 845 (2003).

discount from its pro rata value. Carney and Heimendinger believe that this doctrine has resulted in inflated awards to dissenting shareholders because it forces the Delaware courts to add a "control premium" to firm values in order to properly compensate them. This result is unfair because public investors, they argue, lack the power to influence the policies of a firm with respect to the risk of investments, distribution policies, and agency costs, all features inherent in control. Further, they have no expectation of receipt of a control premium where a control block is sold. Public investors do not receive "equal" treatment in freeze-outs by an existing control shareholder because the power of control shareholders to freeze out minorities is well established and the fairness of the terms are not subject to ready monitoring when the value of the newly privatized firm is not observable. Accordingly, if public investors discount the price they pay for shares to reflect all these factors that create the "minority discount," then compensating them on the basis of the same "minority discount" is not unfair. They then go on to argue that a rule of "no minority discounts" is more consistent with the statutory framework than the existing Delaware jurisprudence.

Lawrence Hamermesh focuses on a different tension in Delaware law in *Premiums in Stock-for-Stock Mergers and Some Consequences in the Law of Director Fiduciary Duties.*[18] Delaware takeover jurisprudence draws distinctions between stock-for-cash and stock-for-stock deals, and between transactions in which control is transferred and transactions where it remains in the market. Hamermesh juxtaposes these distinctions with the observation that merger premia in stock-for-stock and stock-for-cash transactions are basically identical, thus raising "doubts about the utility of change of control as a touchstone for determining the appropriate level of judicial review of director action in the merger context."[19] Indeed, he argues, a critical factor in explaining the allocation of merger gains is the presence or absence of shareholder voting rights. This leads Hamermesh to suggest that "substantial impairment of such rights by unilateral director action should occasion enhanced judicial scrutiny."[20] Finally, he makes a more general point about the focus of judicial (and scholarly) concern on target shareholders when, in fact, shareholders of the acquiring firms have less legal protection, and worse financial outcomes,

---

[18] Lawrence Hamermesh, *Premiums in Stock-for-Stock Mergers and Some Consequences in the Law of Director Fiduciary Duties*, 152 U. PA. L. REV. 881 (2003).

[19] *Id.* 911.

[20] *Id.*

than shareholders of target firms. Perhaps, he provocatively suggests, the courts should focus solely on protecting shareholders' "voting rights where they are afforded, but otherwise treat both sets of directors identically."[21]

David Skeel then turns our attention to control contests in the bankruptcy context and draws parallels in the legal treatments. In *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*,[22] Skeel examines the changes over the last decade in the contestability of control over firms in Chapter 11. While at the beginning of the period, Chapter 11 seemed to take forever, it now moves quickly. Interestingly, this change occurred while the legal structure has remained largely static. The major drivers of these changes, Skeel argues, are two-fold: the contractual arrangements that creditors have inserted into the debtor-in-possession financing; and the changes in the managerial compensation structure. In both areas, creditors have insisted on terms that incentivize managers to bring about the company's quick emergence from Chapter 11.

VIEWS FROM THE BENCH

Finally, we were fortunate to have the active participation of members of the Delaware courts. In *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*,[23] Chancellor William B. Chandler III and Vice-Chancellor Leo E. Strine, Jr. of the Delaware Chancery Court examine the changes in the corporate law landscape driven by the enactment of the Sarbanes-Oxley Act and the associated changes in SEC rules and in stock exchange listing agreements. Chandler and Strine try to "anticipate some of the more interesting potential implications of the 2002 Reforms for substantive state corporation law," and note in particular that the changes "represent a marked increase in the role of the federal government and [e]xchange regulation in the corporate boardroom."[24] As they show, the 2002 Reforms represent a departure from the managerial freedom permitted to directors by state corporation law, and instead prescribe a host of specific procedures and

---

[21] *Id.* at 912.

[22] David Skeel, *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917 (2003).

[23] William B. Chandler III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. 953 (2003).

[24] *Id.* at 958.

mechanisms that corporate boards must employ in the governance of their firms. These changes, they argue, "will fuel a new round of dialogue among the three sources of corporate governance policy that predominate in the American system: the federal government (principally through the SEC), state governments (through their corporate codes and the common law of corporations), and the Stock Exchanges (through their rules and listing requirements)."[25]

Lastly, in *Musings on the Dynamics of Corporate Governance Issues, Director Liability Concerns, Corporate Control Transactions, Ethics, and Federalism*,[26] Chief Justice E. Norman Veasey provides a concise summary of the corporate control debate as viewed from the Delaware bench. In his view, current Delaware law does not fully accommodate either a shareholder choice or a management discretion regime. Instead, the Delaware courts acknowledge that the main purpose of the corporation is to maximize stockholders' wealth, while at the same time giving directors the power to use poison pills to block takeover offers even if they may appear to be in the best interests of the stockholders. Recent changes in federal law (namely, the Sarbanes-Oxley Act of 2002) and stock exchange rules will not shift drastically the locus of corporate governance issues away from state law and, as a result, the debate will continue. With each new case comes the potential to alter or clarify existing doctrine and, accordingly, the potential to raise new issues for new symposia.

Collectively, these articles represent the best of current corporate law scholarship. They are both theoretically sophisticated and practically grounded. The articles address issues of enormous current importance, yet push beyond narrow debates to reexamine the key issues in corporate control contractions: the role of the board, the role of the shareholders, and the role of the capital markets.

---

[25] *Id.* at 958.

[26] E. Norman Veasey, *Musings on the Dynamics of Corporate Governance Issues, Director Liability Concerns, Corporate Control Transactions, Ethics, and Federalism*, 152 U. PA. L. REV. 1007 (2003).